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Sheet and Income Statement for each majority-owned subsidiary included in the consolidated statements.

B. Although Statement No. 94 requires the consolidation of majority-owned subsidiaries, the RUS Form 479, Financial and Statistical Report for Telecommunications Borrowers, shall be prepared on an unconsolidated basis by all borrowers.

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AUTHORITY: 7 U.S.C. 901 *et seq.*; 7 U.S.C. 1921 *et seq.*; Pub. L. 103–354, 108 Stat. 3178 (7 U.S.C. 6941 *et seq.*).

SOURCE: 56 FR 63360, Dec. 3, 1991, unless otherwise noted.

Subpart A—General Provisions

§ 1773.1 General.

(a) This part implements those standard provisions of the security instrument utilized by the Rural Utilities Service (RUS) for both electric and telephone borrowers and by the Rural Telephone Bank (RTB) for its telephone borrowers. The provisions require borrowers to prepare and furnish to RUS, at least once during each 12-month period, a full and complete report of its financial condition, operations, and cash flows, in form and substance satisfactory to RUS, audited and certified by an independent certified public accountant (CPA), satisfactory to RUS, and accompanied by a report of such audit, in form and substance satisfactory to RUS.

(b) This part 1773 applies to both RUS and RTB borrowers. For the purposes of RTB borrowers, as used in this part 1773, *RUS* means *RTB* and *Administrator* means *Governor* unless the text indicates otherwise.

(c) This part complies with the 1994 revision of Government Auditing Standards, issued by the Comptroller General of the United States, United States General Accounting Office.

(d) An auditor's report, report on compliance, report on internal controls, and management letter are required to meet the reporting provisions of the RUS security instrument.

(1) The auditor's report must state that the audit was conducted in accordance with generally accepted government auditing standards (GAGAS).

(2) The management letter must state that the audit was conducted in accordance with this part.

(3) A report of the audit, in form and substance satisfactory to RUS, cannot be issued unless and until an audit has been performed in accordance with GAGAS and this part.

(4) A borrower is in violation of provisions of its security instrument with RUS if the borrower fails to provide an audit performed in compliance with GAGAS and this part. RUS security instruments normally provide for notice and an opportunity to cure such violations before RUS can exercise certain remedies.

(5) A report prepared in connection with a review or compilation of financial statements, as defined in Statement of Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements, does not satisfy the requirements of the RUS security instrument.

(6) A report, as described in Statement on Auditing Standards (SAS) No. 62, entitled "Special Reports", or in SAS No. 35, entitled "Special Reports—Applying Agreed-upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement", does not satisfy the RUS loan security instrument requirements.

(7) An annual report containing audited financial statements does not satisfy the RUS security instrument requirements.

(e) This part further implements those provisions of the standard RUS security instrument by setting forth the criteria for CPAs to be deemed satisfactory to RUS and the audit procedures and documentation standards that must be performed before a report of the audit satisfactory to RUS can be prepared and issued.

[56 FR 63360, Dec. 3, 1991, as amended at 61 FR 107, Jan. 3, 1996]

§ 1773.2 Definitions.

As used in this part:

Administrator means the Administrator of RUS and, as provided in § 1773.2 (b), *Governor*.

AICPA means the American Institute of Certified Public Accountants.

Audit means an examination of financial statements by an independent CPA

for the purpose of expressing an opinion on the fairness with which those statements present financial position, results of operations, and changes in cash flows in conformity with generally accepted accounting principles (GAAP) and for determining whether the borrower has complied with applicable laws, regulations, and contracts for those transactions and events reflected in the financial statements.

BAD means the Borrower Accounting Division of RUS.

CPA means certified public accountant. The terms *CPA* and *CPA firm* are used interchangeably.

FFB means the Federal Financing Bank, an instrumentality and wholly owned corporation of the United States.

GAAP means generally accepted accounting principles.

GAGAS means generally accepted government auditing standards as set forth in Government Auditing Standards, Standards for Audit of Governmental Organizations, Programs, Activities, and Functions, issued by the Comptroller General of the United States.

GAO means the General Accounting Office.

Governor means the Governor of the RTB.

Illegal act has the meaning prescribed in SAS No. 54, entitled "Illegal Acts by Clients".

Irregularity has the meaning prescribed in SAS No. 53, entitled "The Auditor's Responsibility to Detect and Report Errors and Irregularities".

OIG means the Office of Inspector General, United States Department of Agriculture.

OMB means the Office of Management and Budget.

PCPS means the Private Companies Practice Section of the AICPA.

REA means the Rural Electrification Administration formerly an agency of the United States Department of Agriculture and predecessor agency to RUS with respect to administering certain electric and telephone loan programs.

Regulatory asset means an asset resulting from an action of a regulator as prescribed in Statement of Financial Accounting Standards (SFAS) No. 71,

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entitled "Accounting for the Effects of Certain Types of Regulation".

Regulatory liability means a liability imposed on a regulated enterprise by an action of a regulator as prescribed in SFAS No. 71, entitled "Accounting for the Effects of Certain Types of Regulation".

Related party has the meaning prescribed in SFAS No. 57, entitled "Related Party Disclosures".

Related party transaction has the meaning prescribed in SFAS No. 57, entitled "Related Party Disclosures".

Reportable condition has the meaning prescribed in SAS No. 60, entitled "Communication of Internal Control Structure Related Matters Noted in an Audit".

RTB means the Rural Telephone Bank.

RUS means the Rural Utilities Service, an agency of the United States Department of Agriculture established pursuant to Section 232 of the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 (Pub. L. 103-354, 108 Stat. 3178), successor to REA with respect to administering certain electric and telephone programs. See 7 CFR 1700.1.

SAS means Statement on Auditing Standards as prescribed by the AICPA.

SEC Practice Section means the Securities and Exchange Commission Practice Section of the AICPA.

SFAS means Statements of Financial Accounting Standards as prescribed by the Financial Accounting Standards Board.

State means any state or territory of the United States, or the District of Columbia.

Uniform System of Accounts means, for telephone borrowers, the Uniform System of Accounts for Telecommunications Companies, prescribed by the Federal Communications Commission and set forth at 47 CFR part 32, as supplemented by RUS pursuant to 7 CFR part 1770, Accounting Requirements for RUS Telephone Borrowers, subpart B, Uniform System of Accounts, and, for electric borrowers, the Uniform System of Accounts Prescribed for Electric Borrowers of the RUS.

[56 FR 63360, Dec. 3, 1991, as amended at 59 FR 66440, Dec. 27, 1994; 60 FR 2874, Jan. 12, 1995]

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Subpart B—RUS Audit Requirements

§ 1773.3 Annual audit.

(a) Each borrower must have its financial statements audited annually by a CPA selected by the borrower and approved by RUS as set forth in § 1773.4.

(b) Each borrower must establish an annual as of audit date within twelve months of the date of receipt of the first advance of RUS or FFB loan funds and must prepare financial statements as of the date established.

(c) Until all loans made or guaranteed by RUS have been repaid, the borrower must furnish three copies of the auditor's report, report on compliance, report on internal controls, and management letter to RUS within 120 days of the as of audit date.

(d) A borrower that qualifies as a unit of state or local government or Indian tribe as such terms are defined in the Single Audit Act of 1984 (31 U.S.C. 7501 *et seq.*) and OMB Circular A-128, Audits of State and Local Governments, must comply with this part as follows:

(1) A borrower that receives total Federal financial assistance equal to or in excess of \$100,000 during the fiscal year, must have an audit performed and submit an auditor's report meeting the requirements of the Single Audit Act of 1984 (31 U.S.C. 7501 *et seq.*).

(2) A borrower that receives total Federal financial assistance of between \$25,000 and \$100,000 during the fiscal year must have an audit performed in accordance with either the requirements of the Single Audit Act of 1984 (31 U.S.C. 7501 *et seq.*) or this part.

(3) A borrower that receives less than \$25,000 in total Federal financial assistance during the fiscal year must have an audit performed in accordance with the requirements of this part.

(4) A borrower must notify RUS, in writing, within 30 days of the as of audit date, of the total Federal financial assistance received during the audit year and must state whether it will have an audit performed in accordance with the Single Audit Act of 1984 (31 U.S.C. 7501 *et seq.*) or this part.

(i) A borrower that elects to comply with this part must select a CPA that

meets the qualifications set forth in § 1773.5.

(ii) If an audit is performed in accordance with the Single Audit Act of 1984 (31 U.S.C. 7501 *et seq.*), an auditor's report that meets the requirements of the Single Audit Act of 1984 (31 U.S.C. 7501 *et seq.*) will be sufficient to satisfy that borrower's obligations under this part.

(e) OMB Circular A-133, Audits of Institutions of Higher Education and Other Nonprofit Organizations, does not apply to audits of RUS borrowers.

[56 FR 63360, Dec. 3, 1991, as amended at 59 FR 659, Jan. 6, 1994]

§ 1773.4 Borrower responsibilities.

(a) *Selection of a qualified CPA.* The borrower's board of directors is responsible for the selection of a qualified CPA that meets the requirements set forth in § 1773.5. When selecting a CPA, the borrower should consider, among other matters:

(1) The qualifications of CPAs available to do the work;

(2) The CPA's experience in performing audits of utilities; and

(3) The CPA's ability to complete the audit and submit the reports and management letter within 90 days of the as of audit date.

(b) *Board approval of selection.* The board's approval of a CPA must be recorded by a board resolution that states:

(1) The CPA meets RUS's qualifications to perform an audit; and

(2) The borrower and CPA will enter into an audit agreement in accordance with § 1773.6.

(c) *Notification of selection.* When the initial selection or subsequent change of a CPA by a borrower has been made, the borrower must notify RUS, in writing, at least 90 days prior to the as of audit date.

(1) RUS will notify the borrower, in writing, within 30 days of the date of receipt of such notice, if the selection or change in CPA is not satisfactory.

(2) Notification to RUS that the same CPA has been selected for succeeding audits of the borrower's financial statements is not required; however, the procedures outlined in this part must be followed for each new CPA selected, even though such CPA may pre-

viously have been approved by RUS to audit records of other RUS borrowers. Changes in the name of a CPA firm are considered to be a change in the CPA.

(d) *Audit agreement.* The borrower must enter into an audit agreement with the CPA that complies with § 1773.6.

(e) *Debarment certification.* The borrower is responsible for the receipt, from the selected CPA, of a lower tier covered transaction certification, as required under the provisions of Executive Orders 12549 and 12689, Debarment and Suspension, and any rules or regulations issued thereunder.

(f) *Submission of auditor's report.* The borrower must submit to RUS the required auditor's report, report on compliance, report on internal controls, and management letter as set forth in § 1773.21.

(1) An annual auditor's report, report on compliance, report on internal controls, and management letter that fail to meet the requirements detailed in this part will be returned to the borrower with a written explanation of noncompliance.

(2) The borrower must, within 60 days of the date of the letter detailing the noncompliance, submit corrected reports to RUS.

(3) If corrected reports are not received within 60 days of the date of the letter detailing the noncompliance, RUS may notify the borrower that a default has occurred under its security instrument or take other appropriate action. The default notice will set forth the period of time during which the default will be remedied.

(g) *Submission of plan of corrective action.* The borrower must submit written comments to RUS on the findings and recommendations in the auditor's report, report on compliance, report on internal controls, and management letter. The borrower must also submit to RUS:

(1) A written plan for corrective action taken or planned; and

(2) Comments on the status of corrective action taken on previously reported findings and recommendations.

If corrective action is not necessary, a written statement describing the reason it is not should accompany the auditor's report.

§ 1773.5 Qualifications of CPA.

For purposes of the RUS standard security instrument, any CPA that meets the qualifications criteria of this section and enters into an audit agreement with the borrower that complies with § 1773.6, will be considered satisfactory to RUS.

(a) *Certification.* The accountant that audits the financial statements of an RUS borrower must be a CPA in good standing of some state. The CPA does not have to be licensed by the state in which the borrower is located; however, the CPA must abide by the rules and regulations of professional conduct promulgated by the accountancy board of the state in which the borrower is located.

(b) *Independence.* The CPA must be independent. A CPA will be considered independent if the CPA:

(1) Meets the standards for independence contained in the AICPA Code of Professional Conduct in effect at the time the CPA's independence is under review;

(2) Does not have and has not had any direct financial interest or any material indirect financial interest in the borrower during the period covered by the audit; and

(3) Is not and was not, during the period under audit, connected with the borrower as a promoter, underwriter, trustee, director, officer, or employee.

(c) *Peer review requirement.* The CPA must belong to and participate in a peer review program, and must have undergone a satisfactory peer review of the accounting and audit practice conducted by an approved peer review program under paragraph (c)(4) of this section, unless a waiver is granted under paragraph (c)(7) of this section. The reviewing organization must not be affiliated with or have had its most recent peer review conducted by the organization currently being reviewed (reciprocal reviews). After the initial peer review has been performed, the CPA must undergo a peer review of the accounting and audit practice within 42 months of the previous "as of" peer review date or at such additional times as designated by the peer review executive committee.

(1) A CPA that receives an unqualified peer review report will be satisfac-

tory to RUS provided that the CPA meets the other criteria set forth in this section.

(2) If a CPA receives a qualified or adverse peer review report, the CPA must undergo a second peer review within 18 months of the date of the qualified or adverse report. A CPA that receives an unqualified second peer review report will be satisfactory to RUS provided that the CPA meets the other criteria set forth in this section.

(3) A CPA that receives a second qualified or adverse peer review report will not be satisfactory to RUS.

(4) *Approved peer review programs.* The following peer review programs are approved by RUS:

(i) The peer review programs conducted by the AICPA;

(ii) The peer review program conducted by the regulated audit program group of the National Conference of CPA Practitioners; and

(iii) An independent peer review program that, in RUS's determination, requires its members to:

(A) Ensure that the CPA can legally engage in the practice of certified public accounting;

(B) Adhere to the quality control standards established by the AICPA;

(C) Submit to peer reviews of the CPA's accounting and audit practice every 42 months or at such additional times as designated by its own executive committee; and

(D) Ensure that all professionals in the firm, including CPAs and nonCPAs, take part in the qualifying continuing professional education requirements of GAGAS, as set forth in paragraphs (c)(4)(iii)(D)(1) and (c)(4)(iii)(D)(2). A qualified continuing professional education course is one which meets the standards of the AICPA.

(1) An auditor responsible for planning, directing, conducting, or reporting on government audits must complete, every two years, at least eighty hours of continuing education and training which contributes to the auditor's professional proficiency. At least twenty hours must be completed in any one year of the two-year period; and

(2) An individual responsible for planning, directing, and conducting substantial portions of the field work, or reporting on the government audit

must complete at least 24 of the 80 hours of continuing education and training in subjects directly related to the government environment and to government auditing. If the audited entity operates in a specific or unique environment, auditors must receive training that is related to that environment.

(5) *Notification.* The CPA must notify the Director, BAD, in writing, of participation in a peer review program. RUS will notify the CPA within 60 days of receipt of this notice if the selected peer review program is acceptable.

(6) *Submission of reports.* The CPA must submit to the Director, BAD, a copy of any peer review report and accompanying letter of comment, if any, within 60 days of the date such report and letter of comment are released by the peer review group.

(i) If the peer review report indicates that a follow-up review will be made, the CPA must submit subsequent reports to the Director, BAD, within 60 days of the date such reports are released by the peer review group.

(ii) A peer review report must be submitted to the Director, BAD, at least once every 42 months, or more frequently, if required by the peer review program.

(iii) A copy of the peer review report, accompanying letter of comment, and the partners' inspections must be made available to OGC, upon request.

(7) *Waiver of the peer review requirement.* (i) A CPA may request that the Administrator, RUS, waive the peer review requirement. To be eligible for a waiver, the following criteria must be met:

(A) The firm has been in existence for less than 1 year from the date of the request and has not been previously organized under a different name;

(B) One of the partners organizing the firm has previously, within 18 months preceding the request, worked for a firm that has been peer reviewed and the partner was partner-in-charge of audits of RUS borrowers in the previous firm;

(C) The firm has enrolled in an approved peer review program; and

(D) The firm agrees to have the peer review conducted within 18 months of the date of the RUS waiver.

(ii) Waiver requests must address each of the criteria in paragraph (c)(7)(i) of this section and should be submitted to the Director, Borrower Accounting Division.

(d) *Audit agreement.* The CPA must enter into an audit agreement with the borrower that complies with § 1773.6.

[56 FR 63360, Dec. 3, 1991, as amended at 61 FR 107, Jan. 3, 1996]

§ 1773.6 Audit agreement.

(a) An audit agreement must be entered into between the CPA and the borrower. The audit agreement must set forth the auditor's responsibilities in a financial statement audit, including the responsibilities for testing and reporting on internal controls and compliance with laws and regulations and the nature of any additional testing of internal controls and compliance required by laws and regulations. These responsibilities should be contrasted with the additional procedures that could be performed that would result in additional assurances or opinions on the internal control structure and compliance with laws and regulations. The audit agreement must also include the following:

(1) The borrower and the CPA acknowledge that the audit is being performed and the auditor's report, report on compliance, report on internal controls, and management letter is being issued in order to enable the borrower to comply with the provisions of RUS's security instrument;

(2) The borrower and CPA acknowledge that RUS will consider the borrower to be in violation of its security instrument with RUS if the borrower fails to have an audit performed and documented in compliance with GAGAS and this part;

(3) The CPA represents that he/she meets the requirements under this part to be satisfactory to RUS;

(4) The CPA will perform the audit and will prepare the auditor's report, report on compliance, report on internal controls, and management letter in accordance with the requirements of this part;

(5) The CPA will document the audit work performed in accordance with GAGAS, the professional standards of

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the AICPA, and the requirements of this part;

(6) The CPA will make all audit-related documents, including auditor's reports, workpapers, and management letters available to RUS or its representatives (OGC and GAO), upon request, and will permit the photocopying of all audit-related documents; and

(7) The CPA will follow the requirements of reporting irregularities and illegal acts as outlined in § 1773.9.

(b) The audit agreement may include such additional terms and conditions as the CPA and borrower deem appropriate, including, but not limited to:

(1) The CPA will report all audit findings to the board of directors as required in § 1773.20(b); and

(2) The auditor's report, report on compliance, report on internal controls, and management letter with copies for transmittal to RUS, and supplemental lenders, if applicable, will be submitted to the borrower's board of directors within 90 days of the as of audit date;

(c) A copy of the audit agreement must be available at the borrower's office for inspection by RUS personnel. One copy of the current audit agreement must be maintained in the CPA's workpapers or permanent file.

[56 FR 63360, Dec. 3, 1991, as amended at 61 FR 108, Jan 3, 1996]

§ 1773.7 Audit standards.

(a) The audit must be performed in accordance with GAGAS and this part. The audit must be performed in accordance with GAGAS in effect at the audit date unless the borrower is directed otherwise, in writing, by RUS.

(b) The audit must include such tests of the accounting records and such other auditing procedures that are sufficient to enable the CPA to express an opinion on the financial statements and to issue the required reports on compliance and internal controls and the management letter.

(c) Audit scope limitation. (1) The borrower will not limit the scope of the audit to the extent that the CPA is unable to meet RUS's audit requirements or to provide an unqualified opinion that the financial statements are pre-

sented fairly in conformity with GAAP.

(2) The security instrument provision requiring the submission of a report of the audit is not satisfied if the CPA must qualify the opinion in the auditor's report due to limitations placed on the scope of the audit by the borrower.

(3) If the CPA determines during the audit that an unqualified opinion cannot be issued due to a scope limitation imposed by the borrower, the CPA should use professional judgment to determine what levels of the borrower's management should be informed.

(4) After informing the borrower's management, if the scope limitation is not adequately resolved, the CPA should immediately contact the Director, BAD, RUS, U.S. Department of Agriculture, Washington, DC 20250-1500. The Director, BAD, will endeavor to resolve the matter with the borrower.

§ 1773.8 Audit date.

(a) The annual audit must be performed as of the end of the same calendar month each year unless prior approval to change the as of audit date is obtained, in writing, from RUS.

(1) A borrower may request a change in the as of audit date by writing to the appropriate RUS regional office at least 60 days prior to the newly requested as of audit date.

(2) The time period between the prior as of audit date and the newly requested as of audit date must be no longer than twenty-four months. For example, a borrower that wishes to change its as of audit date from December 31, 19X1, to June 30, must make the change effective no later than June 30, 19X3.

(b) Comparative financial statements must be prepared and audited for the twelve months ending as of the new audit date and for the twelve months immediately preceding that period.

(c) A borrower that changes its as of audit date from December 31, 19X1, to June 30, 19X3, must have the CPA report on statements in the following manner:

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Previously issued statements	Statements prepared as of new audit date
12/31/X1; 12/31/X0 (Statements need not be re-issued).	6/30/X3; 6/30/X2

§ 1773.9 Disclosure of irregularities and illegal acts.

(a) In accordance with GAGAS, the CPA must design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, illegal acts, and noncompliance with the provisions of contracts or grant agreements that could have a direct and material effect on financial statement amounts.

(b) If there is an indication that an irregularity may have occurred or evidence concerning the existence of a possible instance of noncompliance with the provisions of contracts or grant agreements that could have a material direct or indirect effect on the financial statements, the CPA must extend audit steps and procedures to obtain sufficient, competent evidential matter to determine whether, in fact, an irregularity or an instance of noncompliance has occurred and the effect on the borrower's financial statements.

(c) Pursuant to the terms of its audit agreement with the borrower, the CPA must immediately report, in writing, all irregularities and all indications or instances of illegal acts, whether material or not, to:

(1) The president of the borrower's board of directors;

(2) The Director, BAD; and

(3) OIG, as follows:

(i) For the States of Delaware, District of Columbia, Maryland, Pennsylvania, Virginia, West Virginia, Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Puerto Rico, Rhode Island, Vermont and the Virgin Islands, report to USDA-OIG-Audit, Northeast Region, Regional Inspector General, 6505

Belcrest Road, room 428-A, Hyattsville, Maryland 20782;

(ii) For the States of Alabama, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, and Tennessee, report to USDA-OIG-Audit, Southeast Region, Regional Inspector General, 401 W. Peachtree Street, NW., room 2328, Atlanta, Georgia 30365-3520;

(iii) For the States of Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin, report to USDA-OIG-Audit, Midwest Region, Regional Inspector General, 111 N. Canal Street, Suite 1130, Chicago, Illinois 60606;

(iv) For the States of Arkansas, Louisiana, New Mexico, Oklahoma, and Texas, report to USDA-OIG-Audit, Southwest Region, Regional Inspector General, 101 South Main, room 324, Temple, Texas 76501;

(v) For the States of Colorado, Iowa, Kansas, Missouri, Montana, Nebraska, North Dakota, South Dakota, Wyoming, and Utah, report to USDA-OIG-Audit, Great Plains Region, Regional Inspector General, P.O. Box 293, Kansas City, Missouri 64141; and

(vi) For the States of Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Territory of Guam, Trust Territories of Pacific, and Washington, report to USDA-OIG-Audit, Western Region, Regional Inspector General, 555 Battery Street, room 511, San Francisco, California 94111.

[56 FR 63360, Dec. 3, 1991, as amended at 61 FR 108, Jan. 3, 1996]

§ 1773.10 Access to audit-related documents.

Pursuant to the terms of the audit agreement, the CPA must make all audit-related documents, including auditors' reports, workpapers, and management letters available to RUS, or its designated representative, upon request and must permit RUS, or its designated representative, to photocopy all audit-related documents.

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Subpart C—RUS Requirements for the Submission and Review of the Auditor's Report, Report on Compliance, Report on Internal Controls, and Management Letter

§ 1773.20 CPA's submission of the auditor's report, report on compliance, report on internal controls, and management letter.

(a) *Time limit.* As soon as possible after completion of the audit, but within 90 days of the as of audit date, the CPA should deliver the auditor's report, report on compliance, report on internal controls, and management letter to the president of the borrower's board of directors. As a minimum, copies should be provided for each member of the board of directors and the manager. Further, three copies must be provided to the borrower for transmittal to RUS.

(b) *Communication with the board of directors.* In addition to providing sufficient copies of the auditor's report, report on compliance, report on internal controls, and management letter for each member of the borrower's board of directors, RUS requires that the CPA report all audit findings to the borrower's board of directors. RUS recommends that audit findings be communicated orally; however, the communication may be oral or written, at the borrower's discretion. If the information is communicated orally, the CPA must document the communication by appropriate memoranda or notations in the workpapers. If the CPA communicates in writing, a copy of the written communication must be included in the CPA's audit workpapers or permanent file.

(c) *Matters to be communicated.* Matters communicated to the board of directors must include, but are not limited to the matters to be communicated to the audit committee as prescribed in SAS No. 61, entitled "Communication with Audit Committee";:

- (1) The initial selection of and changes in significant accounting policies;
- (2) The methods used to account for significant or unusual transactions and

the effects of significant accounting policies in controversial or emerging areas;

(3) The process utilized by management to formulate significant accounting estimates and the basis for the CPA's conclusions regarding the reasonableness of these estimates;

(4) Audit findings and recommendations, including audit adjustments that either individually or in the aggregate have a significant effect on the borrower's financial statements;

(5) The CPA's responsibility for other information presented with the audited financial statements, any audit procedures performed, and the results thereof;

(6) Any disagreements with management, whether or not satisfactorily resolved, concerning matters that individually or in the aggregate may be significant to the borrower's financial statements or the auditor's report, report on compliance, report on internal controls, or management letter;

(7) Significant matters that were the subject of consultations with other accountants;

(8) Significant issues discussed with management with regard to the initial or recurring retention of the CPA; and

(9) Any serious difficulties encountered in dealing with management during the performance of the audit.

[56 FR 63360, Dec. 3, 1991, as amended at 59 FR 659, Jan. 6, 1994]

§ 1773.21 Borrower's review and submission of the auditor's report, report on compliance, report on internal controls, and management letter.

(a) The borrower's board of directors should note and record receipt of the auditor's report, report on compliance, report on internal controls, and management letter and any action taken in response to the reports or management letter in the minutes of the board meeting at which such reports and management letter are presented.

(b) The borrower must furnish RUS with three copies of the auditor's report, report on compliance, report on internal controls, and management letter within 120 days of the as of audit date. Any provision in RUS's security

instrument that requires such documents to be furnished to RUS in a shorter period of time may be disregarded.

(c) The borrower must furnish RUS with three copies of its plan for corrective action, if any, within 180 days of the as of audit date.

(d) The borrower must furnish RUS, within 120 days of the as of audit date, with a copy of each special report, summary of recommendations or similar communications, if any, received from the CPA as a result of the audit.

[56 FR 63360, Dec. 3, 1991, as amended at 59 FR 659, Jan. 6, 1994]

§§ 1773.22—1773.29 [Reserved]

Subpart D—RUS Reporting Requirements

§ 1773.30 General.

(a) The CPA must prepare the following:

(1) An auditor's report, examples of which are set forth in appendixes A, exhibit 1 (Electric), and B, exhibit 1 (Telephone) of this part 1773;

(2) A report on compliance, examples of which are set forth in appendixes A, exhibits 2 through 4 (Electric) and B, exhibits 2 through 4 (Telephone) of this part 1773;

(3) A report on internal controls, examples of which are set forth in appendixes A, exhibits 5 and 6 (Electric) and B, exhibits 5 and 6 (Telephone) of this part 1773; and

(4) A management letter, an example of which is set forth in appendix C of this part 1773.

(b) The CPA should deliver the auditor's report, report on compliance, report on internal controls, and management letter (with copies as required in § 1773.20) to the borrower as soon as possible after completion of the audit but not more than 90 days after the as of audit date.

§ 1773.31 Auditor's report.

The CPA must prepare a written report on comparative balance sheets, statements of revenue and patronage capital (or income and retained earnings, depending upon the structure of the borrower) and statements of cash flows. This report must be signed by

the CPA, cover all statements presented, and refer to the separate reports on internal controls and on compliance with laws and regulations issued in conjunction with the auditor's report.

[61 FR 108, Jan. 3, 1996]

§ 1773.32 Report on compliance.

(a) As required by GAGAS, the CPA must prepare a written report on the tests performed for compliance with applicable laws, regulations, contracts, and grants. This report must be signed by the CPA and must contain the status of known but uncorrected significant or material findings and recommendations from prior audits that affect the current audit objective.

(b) If, based upon assessments of materiality and audit risk, the CPA concludes that it is not necessary to perform tests of compliance with laws, regulations, and contracts, the CPA must issue a report as illustrated in appendix A, exhibit 2 (Electric) and appendix B, exhibit 2 (Telephone) of this part 1773.

(c) If the CPA determines that testing for compliance with laws, regulations, and contracts is necessary, and no material instances of noncompliance are found, the CPA must issue a report as illustrated in appendix A, exhibit 3 (Electric), and appendix B, exhibit 3 (Telephone) of this part 1773.

(d) If material instances of noncompliance are found, the CPA must issue a report as illustrated in appendix A, exhibit 4 (Electric), and appendix B, exhibit 4 (Telephone) of this part 1773.

(e) Other nonmaterial instances of noncompliance should not be disclosed in the report on compliance but should be reported in a separate communication to the board of directors, preferably in writing. All such communications must be documented in the workpapers.

(f) If the CPA has issued a separate letter detailing immaterial instances of noncompliance, the report on compliance must be modified to include a statement such as:

We noted certain immaterial instances of noncompliance that we have reported to the

§ 1773.33

management of (borrower's name) in a separate letter dated March 2, 19X0.

[56 FR 63360, Dec. 3, 1991, as amended at 61 FR 108, Jan. 3, 1996]

§ 1773.33 Report on internal controls.

As required by GAGAS, the CPA must prepare a written report on the borrower's internal control structure and the assessment of control risk made as part of the financial statement audit. This report must be signed by the CPA and must include, as a minimum:

(a) The scope of the CPA's work to obtain an understanding of the borrower's internal control structure and in assessing the control risk;

(b) A description of the reportable conditions noted which include material weaknesses identified as a result of the CPA's work in understanding and assessing the control risk; and

(c) The status of known but uncorrected, significant or material findings and recommendations from prior audits that affect the current audit objective.

[61 FR 108, Jan. 3, 1996]

§ 1773.34 Management letter.

The CPA must prepare a management letter that includes, at a minimum, comments on:

(a) *Audit procedures.* State whether the audit has been performed in accordance with this part;

(b) *Special reports.* State whether any special reports, summaries of recommendations, or similar communications were furnished to the borrower's management during the course of the audit or during interim audit work, and provide a description of the information furnished;

(c) *Accounting and records.* Comment on the adequacy and effectiveness of the borrower's accounting procedures, discuss the general condition of the records, and outline any recommendations for improvement. Comment on the adequacy and fairness of the methods used in accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or other expense accounts, and where appropriate, include:

7 CFR Ch. XVII (1-1-97 Edition)

(1) Whether subsidiary plant records agree with the controlling general ledger plant accounts;

(2) Whether construction clearing accounts are cleared promptly of costs of completed construction to the proper classified plant accounts and whether depreciation was accrued on such completed construction from the date the plant was placed in service;

(3) Whether retirements of plant are currently and systematically recorded and properly priced;

(4) Whether all costs associated with retirements of plant are properly accounted for in the accumulated provision for depreciation accounts and comment on any unusual charges or credits to such accounts; and

(5) Whether RUS approval was obtained for a sale requiring such approval, and whether receipts from sales of plant, material or scrap were not handled in conformance with RUS requirements.

(d) *Materials control.* Comment on the adequacy of the control over materials and supplies.

(e) *Compliance with RUS loan and security instrument provisions.* State whether the following provisions of RUS's loan and security instruments have been complied with:

(1) For electric borrowers, provisions relating to:

(i) The requirement for funds to be deposited in banks or other depositories designated in the loan documents or approved by RUS. For purposes of this part 1773, funds shall be defined as cash on deposit in demand and time accounts, and certificates of deposit;

(ii) The requirement for a borrower to obtain written approval of mortgagees to enter into any contract for the operation or maintenance of all or any substantial part of its property, or for the use by others of its property. For purposes of this part 1773, the following contracts shall be deemed as requiring RUS approval:

(A) Management contracts in which the borrower has contracted to have another borrower or other entity manage its affairs;

(B) Management contracts in which the borrower has contracted to manage

another borrower or other utility system;

(C) Operations and maintenance contracts in which the borrower has contracted to have another borrower or other entity operate and/or maintain all or a substantial part (45% or more) of the physical plant facilities of the borrower;

(D) Operations and maintenance contracts in which the borrower has contracted to operate and maintain the physical plant facilities of another borrower or other utility system; and

(E) Contracts between the borrower and its manager; and

(iii) The requirement for a borrower to prepare and furnish mortgagees annual financial and statistical reports on the borrower's financial condition and operations. The CPA must state whether the information represented by the borrower as having been submitted to RUS in its most recent December 31 RUS Form 7 or Form 12 is in agreement with the borrower's audited records, and must comment on any exceptions noted. If the borrower represents that an amended report has been filed as of December 31, the comments must relate to the amended report.

(2) For telephone borrowers, provisions relating to:

(i) The requirement for a borrower to obtain written approval of the mortgagees to enter into any contract for the operation or maintenance of property and for the use of mortgaged property by others, or for services pertaining to toll traffic, operator assistance, or switching. For purposes of this part 1773, the following contracts shall be deemed as requiring RUS approval:

(A) Any contract, agreement or lease between the borrower and an affiliate other than as allowed under 7 CFR part 1744, subpart E;

(B) Any lease of a building or land; and

(C) Any other contract as defined in § 1773.34 (e)(2)(i) except:

(I) Industry standard traffic settlement agreements involving interchange and long distance carriers which, in form and substance, conform with contracts in general use in the telecommunications industry;

(2) Billing and collecting agreements;

(3) Toll pooling arrangements involving National Exchange Carrier Association and state associations;

(4) Directory services agreements; and

(5) Joint use agreements;

(ii) The requirement for funds to be deposited in banks or other depositories designated in the loan documents or approved by RUS. For purposes of this part 1773, funds shall be defined as cash on deposit in demand and time accounts, and certificates of deposit; and

(iii) The requirement for a borrower to prepare and furnish mortgagees annual financial and statistical reports on the borrower's financial condition and operations. The CPA must state whether the information represented by the borrower as having been submitted to RUS in its most recent December 31 RUS Form 479 is in agreement with the borrower's audited records, and must comment on any exceptions noted. If the borrower represents that an amended report has been filed as of December 31, the comments must relate to the amended report;

(f) *Related party transactions.* State whether all material related party transactions have been disclosed in the notes to the financial statements in accordance with SFAS No. 57, entitled "Related Party Disclosures". If the audit did not disclose any related party transactions considered to be material, either individually or in the aggregate, so state;

(g) *Depreciation rates.* For electric borrowers, comment when the depreciation rates used in computing monthly accruals are not in compliance with RUS requirements (See RUS Bulletin 183-1, Depreciation Rates and Procedures), which require the use of depreciation rates that are within the ranges established by RUS for each primary plant account, or with the requirements of the State regulatory body having jurisdiction over the borrower's depreciation rates; and

(h) *Deferred debits and deferred credits.* For electric borrowers, provide a detailed analysis of the totals reported as deferred debits and deferred credits, including, but not limited to, margin stabilization plans, revenue deferral plans, and expense deferrals. The CPA must

state whether RUS has approved, in writing, each regulatory asset and liability.

[56 FR 63360, Dec. 3, 1991, as amended at 59 FR 659, Jan. 6, 1994; 61 FR 108, Jan. 3, 1996]

§§ 1773.35–1773.37 [Reserved]

Subpart E—RUS Required Audit Procedures and Documentation

§ 1773.38 Scope of engagement.

(a) RUS requires that the audit procedures set forth in §§ 1773.39 through 1773.45 be performed annually by the CPA during the audit of the RUS borrowers' financial statements, which audit procedures may be in addition to the conduct of a GAGAS audit.

(b) The CPA must exercise professional judgment in determining whether any auditing procedures in addition to those mandated by GAGAS or this part should be performed in order to afford a reasonable basis for rendering the auditor's report, report on compliance, report on internal controls, and management letter.

§ 1773.39 Utility plant and accumulated depreciation.

(a) *General.* The audit of these accounts must include tests of additions, replacements, retirements, and changes. Based upon the CPA's determination of materiality, an appropriate sample of transactions must be selected for testing. The CPA's workpapers must document that he/she:

(1) Examined direct labor and material transactions to determine whether the borrower's accounting records reflect a complete accumulation of costs;

(2) Examined indirect costs and overhead charges to determine if they conform to the Uniform System of Accounts;

(3) Reviewed the costs of completed construction and retirement projects to determine if they were cleared promptly from the work in progress accounts to the classified plant in service accounts and the related depreciation reserves;

(4) Examined direct purchases of special equipment and general plant;

(5) Determined the degree of accuracy and control of costing retire-

ments, including tests of salvage and removal costs;

(6) Reviewed the borrower's work order procedures; and

(7) Reviewed depreciation rates for adequate support, compared them to RUS guidelines, and determined if they are in compliance.

(b) *Construction work in progress.* (1) The workpapers must include a summary of open work orders reconciled to the general ledger. The CPA must note on the summary any unusual or non-typical projects.

(2) Based upon the CPA's determination of materiality, an appropriate sample of work orders must be selected for testing. The CPA's workpapers must document that he/she:

(i) Reviewed equipment purchases charged to work orders, including payments and receiving reports;

(ii) Reviewed contracts showing the scope of the work, the nature of the contract, the contract amount, and scheduled payments and reviewed supporting documents to determine that all services contracted for were in fact rendered;

(iii) Reviewed time cards and pay rates for several employees who allocate their time to work orders;

(iv) Reviewed the nature of material and supplies issued to the project, traced amounts and quantities to supporting documents, and reviewed the reasonableness of clearing rates for assignment of stores expense to the work order;

(v) Reviewed the accuracy of the computation of overheads applied to the work order; and

(vi) Reviewed other costs charged to the work order for support and propriety.

(3) Based upon the CPA's determination of materiality, an appropriate sample of completed contracts must be selected for testing. The CPA's workpapers must document that he/she:

(i) Scheduled payments to contractors and traced to verify payments and supporting invoices;

(ii) Traced contract costs to final closeout documents, to the general ledger, and to the continuing property records; and

(iii) Verified the costs of owner furnished materials, if applicable.

(4) The CPA must review the borrower's procedures for unitization and classification of work order and contract costs. Based upon the CPA's determination of materiality, an appropriate sample of transactions must be selected for testing. The CPA's workpapers must document that he/she:

(i) Reviewed the tabulation of record units for construction from the work order staking sheets to the tabulation of record units, to the unitization sheets, and to the continuing property records;

(ii) Reviewed the procedures for unitizing and distributing costs of completed construction to the plant accounts;

(iii) Verified that standard costs were being used;

(iv) Evaluated the basis for development of standard costs; and

(v) Determined that costs of completed construction were cleared promptly from work in progress accounts.

(c) *Continuing property records.* Based upon the CPA's determination of materiality, an appropriate sample of transactions must be selected for testing. The CPA's workpapers must document that he/she:

(1) Determined whether the subsidiary plant records agree with the controlling general ledger plant accounts;

(2) Noted differences in the workpapers; and

(3) Commented, in the management letter, on any discrepancies.

(d) *Retirement work-in-progress.* Based upon the CPA's determination of materiality, an appropriate sample of transactions must be selected for testing. The CPA's workpapers must document that he/she:

(1) Determined that plant retirements are currently and systematically recorded and priced on the basis of the continuing property records, and determined that costs of removal have been properly accounted for;

(2) Explained the method used in computing the cost of units of plant retired if continuing property records have not been established and deter-

mined whether costs appeared reasonable; and

(3) Determined the manner in which net losses due to retirements were accounted for and traced clearing entries to the depreciation reserve, the plant accounts, and the continuing property records.

(e) *Provision for accumulated depreciation.* The CPA's workpapers must include an analysis of transactions. Based upon the CPA's determination of materiality, an appropriate sample of transactions must be selected for testing. The CPA's workpapers must document that he/she:

(1) Verified the depreciation accruals for the period, including the depreciation base;

(2) Reviewed the basis of the depreciation rates, any change in rates and the reason therefor, and, if appropriate, determined whether the rates are in compliance with RUS requirements or with the requirements of the state regulatory body having jurisdiction over the borrower's depreciation rates;

(3) Reviewed salvage and removal costs; and

(4) Searched for unrecorded retirements.

(f) *Other reserves.* The CPA's workpapers must include an account analysis for all other material plant reserves, such as the reserve for the amortization of plant acquisition adjustments. Based upon the CPA's determination of materiality, an appropriate sample of transactions must be selected for testing. The CPA's workpapers must document that appropriate tests of transactions were performed.

(g) *Narrative.* The CPA must prepare and include in the workpapers a comprehensive narrative on the scope of work performed, observations made, and conclusions reached. Specific matters covered in this narrative must include:

(1) The nature of construction and other additions;

(2) The control over, and the accuracy of pricing retirements;

(3) The accuracy of distributing costs to classified utility plant accounts;

(4) An evaluation of the method of:

(i) Capitalizing the direct loadings on labor and material costs;

- (ii) Distributing transportation costs and other expense clearing accounts; and
- (iii) Capitalizing overhead costs;
- (5) The tests of depreciation;
- (6) A review of agreements such as those relating to acquisitions, property sales, and leases which affect the plant accounts; and
- (7) Notations, if applicable, of RUS approval of property sales and the propriety of the disposition of the proceeds.

§ 1773.40 Regulatory assets.

The CPA's workpapers must document whether all regulatory assets comply with the requirements of SFAS No. 71. For electric borrowers only, the CPA's workpapers must document whether all regulatory assets have received RUS approval.

[59 FR 660, Jan. 6, 1994]

§ 1773.41 Extraordinary retirement losses.

The CPA's workpapers must contain an analysis of retirement losses, including any required approval by a regulatory commission with jurisdiction in the matter, or RUS, in the absence of commission jurisdiction.

§ 1773.42 Clearing accounts.

The CPA's workpapers must contain an analysis of all clearing accounts. Based upon the CPA's determination of materiality, an appropriate sample of transactions should be selected for testing. The CPA's workpapers must document that transactions were reviewed for proper allocation between expense and capital accounts.

§ 1773.43 Capital and equity accounts.

(a) *Capital stock.* For privately owned companies, the workpapers must include analyses of all stock transactions during the audit period. Based upon the CPA's determination of materiality, an appropriate sample of transactions must be selected for testing. The CPA's workpapers must document that he/she:

- (1) Reviewed the subsidiary records and reconciled them to the general ledger control account;

(2) Reviewed authorizations and issuances or redemptions of capital stock for proper approvals by the board of directors, stockholders, and regulatory commissions;

(3) Determined that transactions were made in accordance with the appropriate provisions of the articles of incorporation, bylaws, and RUS loan documents; and

(4) Determined that transactions were recorded in accordance with the Uniform System of Accounts.

(b) *Memberships.* For cooperative organizations, the workpapers must include an analysis of the membership transactions during the audit period. Based upon the CPA's determination of materiality, an appropriate sample of transactions must be selected for testing. The CPA's workpapers must document that he/she:

(1) Reviewed the subsidiary records and reconciled them to the general ledger control account; and

(2) Determined that transactions were made in accordance with the appropriate provisions of the articles of incorporation, bylaws, and RUS loan documents.

(c) *Patronage capital, retained earnings, margins, and other equities.* The workpapers must include an analysis of the patronage capital, retained earnings, margins and other equities, and any related reserve accounts. Based upon the CPA's determination of materiality, an appropriate sample of transactions must be selected for testing. The CPA's workpapers must document that he/she:

(1) Determined that the transactions were made in accordance with the appropriate provisions of the articles of incorporation, bylaws, RUS loan documents, Uniform System of Accounts, or orders of regulatory commissions;

(2) Traced payments to underlying support; and

(3) Determined whether, under the terms of the RUS security instrument, restrictions of retained earnings or margins are required and, if so, whether they have been properly recorded.

§ 1773.44 Long-term debt.

The CPA's workpapers must document that he/she:

- (a) Confirmed RUS, FFB, and RTB debt to the appropriate confirmation schedule (RUS Form 690, Confirmation Schedule Obligation to the FFB as of; or Form 691, Confirmation Schedule—Long-term Obligation to RUS as of; or RTB Form 12, Confirmation Schedule);
- (b) Confirmed other long-term debt directly with the lender;
- (c) Examined notes executed or canceled during the audit period; and
- (d) Tested accrued interest computations.

§ 1773.45 Regulatory liabilities.

The CPA's workpapers must document whether all regulatory liabilities comply with the requirements of SFAS No. 71. For electric borrowers only, the CPA's workpapers must document whether all regulatory liabilities have received RUS approval.

[59 FR 660, Jan. 6, 1994]

§§ 1773.46—1773.49 [Reserved]

APPENDIX A TO PART 1773—SAMPLE AUDITOR'S REPORT FOR AN ELECTRIC COOPERATIVE

Appendix A includes an example of an auditor's report, report on compliance, report on internal controls, financial statements and accompanying notes for an electric distribution cooperative. The sample auditor's report is intended as a guide only and, while it is recommended that the format be followed, each auditor's report should be prepared to adequately cover the circumstances. To the extent possible, it should be used as a guide in preparing auditors' reports for other types of electric borrowers. For power supply borrowers and for distribution borrowers with production or transmission plant, the same general format should be followed. However, the Statement of Revenue and Patronage Capital must be expanded to show separate totals for operations expenses and maintenance expenses for each class of production plant and for transmission plant.

Exhibit 1—Sample Auditor's Report

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center County Electric Cooperative:

INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying balance sheets of Center County Electric Cooperative as of December 31, 19X9 and 19X8, and the related statements of revenue and patronage capital, and cash flows for the years

then ended. These financial statements are the responsibility of Center County Electric Cooperative's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Center County Electric Cooperative as of December 31, 19X9 and 19X8, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In accordance with Government Auditing Standards, we have also issued a report dated March 2, 19X0, on our consideration of Center County Electric Cooperative's internal control structure and a report dated March 2, 19X0, on its compliance with laws and regulations.

Certified Public Accountants

March 2, 19X0

Exhibit 2—Sample Report on Compliance When, Based on Assessments of Materiality and Audit Risk, the CPA Concluded It Was Not Necessary to Perform Tests of Compliance With Laws and Regulations

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center County Electric Cooperative:

We have audited the financial statements of Center County Electric Cooperative as of and for the years ended December 31, 19X9 and 19X8, and have issued our report thereon dated March 2, 19X0.

We conducted our audits in accordance with generally accepted auditing standards and the Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to Center County Electric Cooperative is the responsibility

of Center County Electric Cooperative's management. As part of our audit, we assessed the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants could cause the financial statements to be materially misstated. We concluded that the risk of such material misstatement was sufficiently low that it was not necessary to perform tests of Center County Electric Cooperative's compliance with such provisions of laws, regulations, contracts, and grants.

This report is intended for the information of the audit committee, management, the Rural Utilities Service, and supplemental lenders. However, this report is a matter of public record and its distribution is not limited.

Certified Public Accountants

March 2, 19X0

Exhibit 3—Sample Report on Compliance When, Based on Assessments of Materiality and Audit Risk, the CPA Performed Compliance Testing and Found No Reportable Instances of Noncompliance

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center County Electric Cooperative:

We have audited the financial statements of Center County Electric Cooperative as of and for the years ended December 31, 19X9 and 19X8, and have issued our report thereon dated March 2, 19X0.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to Center County Electric Cooperative is the responsibility of Center County Electric Cooperative's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of Center County Electric Cooperative's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under Government Auditing Standards.

This report is intended for the information of the audit committee, management, the Rural Utilities Service, and supplemental lenders. However, this report is a matter of

public record and its distribution is not limited.

Certified Public Accountants

March 2, 19X0

Exhibit 4—Sample Report on Compliance When, Based on Assessments of Materiality and Audit Risk, the CPA Performed Compliance Testing and Found Reportable Instances of Noncompliance

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center County Electric Cooperative:

We have audited the financial statements of Center County Electric Cooperative as of and for the years ended December 31, 19X9 and 19X8, and have issued our report thereon dated March 2, 19X0.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to Center County Electric Cooperative is the responsibility of Center County Electric Cooperative's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of Center County Electric Cooperative's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed instances of noncompliance that are required to be reported herein under Government Auditing Standards for which the ultimate resolution cannot presently be determined. Accordingly, no provision for any liability that may result has been recognized in Center County Electric Cooperative's 19X9 and 19X8 financial statements.

[Include paragraphs describing the instances of noncompliance noted.]

We considered these instances of noncompliance in forming our opinion on whether Center County Electric Cooperative's 19X9 and 19X8 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not effect our report dated March 2, 19X0, on those financial statements.

This report is intended for the information of the audit committee, management, the Rural Utilities Service, and supplemental lenders. However, this report is a matter of

public record and its distribution is not limited.

Certified Public Accountants

March 2, 19X0

*Exhibit 5—Sample Report on Internal Controls
When Reportable Conditions Were Found*

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center County Electric Cooperative:

We have audited the financial statements of Center County Electric Cooperative as of and for the years ended December 31, 19X9 and 19X8, and have issued our report thereon dated March 2, 19X0.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of Center County Electric Cooperative is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgements by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that the assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of Center County Electric Cooperative for the years ended December 31, 19X9 and 19X8, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure.

Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgement, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[Include paragraphs to describe the reportable conditions noted.]

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of Center County Electric Cooperative in a separate letter dated March 2, 19X0.

This report is intended for the information of the audit committee, management, the Rural Utilities Service, and supplemental lenders. However, this report is a matter of public record, and its distribution is not limited.

Certified Public Accountants

March 2, 19X0

*Exhibit 6—Sample Report on Internal Controls
When No Reportable Conditions Were Found*

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center County Electric Cooperative:

We have audited the financial statements of Center County Electric Cooperative, as of and for the years ended December 31, 19X9 and 19X8, and have issued our report thereon dated March 2, 19X0.

We conducted our audits in accordance with generally accepted auditing standards

and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of Center County Electric Cooperative is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of Center County Electric Cooperative for the years ended December 31, 19X9 and 19X8, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and proce-

dures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted other matters involving the internal control structure and its operation that we have reported to the management of Center County Electric Cooperative in a separate letter dated March 2, 19X0.

This report is intended for the information of the audit committee, management, the Rural Utilities Service, and supplemental lenders. However, this report is a matter of public record, and its distribution is not limited.

Certified Public Accountants

March 2, 19X0

EXHIBIT 7 - SAMPLE FINANCIAL STATEMENTS

CENTER COUNTY ELECTRIC COOPERATIVE
BALANCE SHEETS - DECEMBER 31, 19X9 AND 19X8
ASSETS (Notes 1 and 2)

	<u>19X9</u>	<u>19X8</u>
ELECTRIC PLANT: (Note 3)		
In Service - at cost	\$9,524,646	\$9,365,264
Construction Work in Progress	<u>407,943</u>	<u>317,166</u>
	9,932,589	9,682,430
Less: Accumulated Provisions for Depreciation	<u>3,117,629</u>	<u>2,917,295</u>
	<u>6,814,960</u>	<u>6,765,135</u>
OTHER ASSETS AND INVESTMENTS:		
Nonutility Property	20,227	20,227
Investments in Associated Organizations (Note 4)	<u>391,258</u>	<u>292,798</u>
	<u>411,485</u>	<u>313,025</u>
CURRENT ASSETS:		
Cash - General Funds	37,350	51,544
Cash - Construction Funds	10,034	20,193
Accounts Receivable (Less accumulated provision for uncollectible accounts of \$2,207 in 19X9 and \$1,933 in 19X8)	36,527	35,255
Materials and Supplies (at average cost)	83,652	80,882
Other Current and Accrued Assets	<u>8,613</u>	<u>8,692</u>
	<u>176,176</u>	<u>196,566</u>
DEFERRED CHARGES (Note 5):	<u>5,666</u>	<u>1,762</u>
	<u>\$7,408,287</u>	<u>\$7,276,488</u>

The accompanying notes are an integral part of these statements.

CENTER COUNTY ELECTRIC COOPERATIVE
BALANCE SHEETS - DECEMBER 31, 19X9 and 19X8
EQUITIES AND LIABILITIES (Note 1)

	<u>19X9</u>	<u>19X8</u>
EQUITIES:		
Memberships	\$ 60,145	\$ 59,440
Patronage Capital (Note 6)	1,761,798	1,526,833
Other Equities (Note 7)	<u>53,647</u>	<u>35,900</u>
	<u>1,875,590</u>	<u>1,622,173</u>
LONG-TERM DEBT:		
REA Mortgage Notes less current maturities (Note 8)	5,249,115	5,396,385
CURRENT LIABILITIES:		
Current Maturities of Long-Term Debt	145,000	140,000
Accounts Payable - Purchased Power	48,916	52,117
Accounts Payable - Other	21,859	6,556
Consumer Deposits	32,660	33,085
Accrued Taxes	10,958	9,146
Other Current and Accrued Liabilities	<u>12,285</u>	<u>6,461</u>
	<u>271,678</u>	<u>247,365</u>
DEFERRED CREDITS (Note 10):	<u>11,904</u>	<u>10,565</u>
	<u>\$7,408,287</u>	<u>\$7,276,488</u>

The accompanying notes are an integral part of these statements.

CENTER COUNTY ELECTRIC COOPERATIVE
STATEMENTS OF REVENUE AND PATRONAGE CAPITAL
FOR THE YEARS ENDED DECEMBER 31, 19X9 and 19X8

	<u>19X9</u>	<u>19X8</u>
OPERATING REVENUES:	\$1,719,467	\$1,605,690
OPERATING EXPENSES:		
Cost of Power	587,729	625,411
Distribution - Operation	111,058	121,682
Distribution - Maintenance	158,622	182,740
Consumer Accounts	76,675	72,927
Sales	38,378	40,755
Administrative and General	94,682	87,058
Depreciation and Amortization	288,389	279,776
Taxes	<u>34,920</u>	<u>34,438</u>
	<u>1,390,453</u>	<u>1,444,787</u>
OPERATING MARGINS BEFORE FIXED CHARGES	329,014	160,903
FIXED CHARGES:		
Interest on Long-Term Debt	<u>113,713</u>	<u>115,082</u>
OPERATING MARGINS AFTER FIXED CHARGES	215,301	45,821
G&T AND OTHER CAPITAL CREDITS	<u>14,460</u>	<u>17,500</u>
NET OPERATING MARGINS	<u>229,761</u>	<u>63,321</u>
NONOPERATING MARGINS:		
Interest Income	24,289	18,802
Other Nonoperating Income	<u>1,200</u>	<u>1,200</u>
	<u>25,489</u>	<u>20,002</u>
NET MARGINS	255,250	83,323
PATRONAGE CAPITAL - BEGINNING OF YEAR	<u>1,526,833</u>	<u>1,469,125</u>
	1,782,083	1,552,448
RETIREMENT OF CAPITAL CREDITS	<u>20,285</u>	<u>25,615</u>
PATRONAGE CAPITAL - END OF YEAR	<u>\$1,761,798</u>	<u>\$1,526,833</u>

The accompanying notes are an integral part of these statements.

CENTER COUNTY ELECTRIC COOPERATIVE
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 19X9 AND 19X8

	<u>19X9</u>	<u>19X8</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash Received from Consumers	\$1,721,496	\$1,609,933
Cash Paid to Suppliers and Employees	(1,049,139)	(1,126,367)
Interest Received	24,289	18,802
Interest Paid	(114,131)	(115,607)
Taxes Paid	<u>(33,108)</u>	<u>(32,132)</u>
Net Cash Provided by Operating Activities	549,407	354,629
CASH FLOWS FROM INVESTING ACTIVITIES:		
Construction and Acquisition of Plant	(322,234)	(216,427)
Plant Removal Costs	(25,994)	(19,268)
Materials Salvaged from Retirements	10,014	7,327
(Increase)/Decrease In:		
Materials Inventory	(2,770)	1,916
Deferred Charges-Preliminary Survey & Investigation	(3,486)	(2,617)
Investments-CFC Capital Term Certificates	(82,472)	(69,412)
Inventory Adjustment-Deferred Credit Decrease	<u>(2,290)</u>	<u>(1,057)</u>
Net Cash Used in Investing Activities	(429,232)	(299,538)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Retirements of Patronage Capital Credits	(20,285)	(25,615)
Retired Capital Credits - Gain	1,200	1,200
Donated Capital	16,547	6,178
REA Loan Advances	174,976	197,450
Payments on REA Debt	(317,246)	(279,575)
Increase/(Decrease) In:		
Consumer Deposits	(425)	575
Memberships Issued	<u>705</u>	<u>450</u>
Net Cash Used in Financing Activities	<u>(144,528)</u>	<u>(99,337)</u>
Net Increase/(Decrease) in Cash	(24,353)	(44,246)
Cash - Beginning of Year	<u>71,737</u>	<u>115,983</u>
Cash - End of Year	<u>\$ 47,384</u>	<u>\$ 71,737</u>

The accompanying notes are an integral part of these statements.

CENTER COUNTY ELECTRIC COOPERATIVE
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 19X9 AND 19X8

RECONCILIATION OF NET MARGINS TO NET CASH PROVIDED
BY OPERATING ACTIVITIES:

	<u>19X9</u>	<u>19X8</u>
Net Margins	\$ 255,250	\$ 83,323
Adjustments to Reconcile Net Margins to Net Cash Provided by Operating Activities:		
Depreciation and Amortization	288,389	279,776
G&T and Other Capital Credits (Non-Cash)	(14,460)	(17,500)
Patronage Capital Credits-NRUCFC (Non-Cash)	(1,528)	(1,200)
Provision for Uncollectible Accounts Receivable	274	(526)
(Increase)/Decrease In:		
Customer and Other Accounts Receivable	(1,546)	2,523
Current and Accrued Assets-Other	79	112
Increase/(Decrease) In:		
Accounts Payable	12,102	5,117
Accrued Taxes	1,812	2,306
Deferred Energy Prepayments	3,629	2,246
Current and Accrued Liabilities- Other	5,824	(1,023)
Deferred Interest Expense	<u>(418)</u>	<u>(525)</u>
Total Adjustments	<u>294,157</u>	<u>271,306</u>
Net Cash Provided by Operating Activities	<u>\$ 549,407</u>	<u>\$ 354,629</u>

The accompanying notes are an integral part of these statements.

CENTER COUNTY ELECTRIC COOPERATIVE
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 19X9 AND DECEMBER 31, 19X8

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Include a brief description of the reporting entity's significant accounting policies in accordance with Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies.

Disclosure of accounting policies should identify and describe the accounting principles followed by the borrower and the methods of applying those principles that materially affect the determination of financial position, cash flow, and results of operations.

Disclosures of accounting policies do not have to be duplicated in this section if presented elsewhere as an integral part of the financial statements.

2. ASSETS PLEDGED:

Substantially all assets are pledged as security for long-term debt to REA.

3. ELECTRIC PLANT AND DEPRECIATION RATES AND PROCEDURES:

Listed below are the major classes of the electric plant as of December 31, 19X9, and 19X8:

	<u>19X9</u>	<u>19X8</u>
Intangible Plant	\$ 2,194	\$ 2,194
Distribution Plant	9,011,036	8,873,957
General Plant	<u>511,416</u>	<u>489,113</u>
Electric Plant in Service	9,524,646	9,365,264
Construction Work in Progress	<u>407,943</u>	<u>317,166</u>
	<u>\$9,932,589</u>	<u>\$9,682,430</u>

Provision has been made for depreciation of distribution plant at a straight-line composite rate of 2.86 percent per annum.

General Plant depreciation rates have been applied on a straight-line basis as follows:

Structures and Improvement	2.5%
Office Furniture	6.0%
Transportation Equipment	14.0%
Power Operated Equipment	12.0%
Other General Plant	4.0%
Communications Equipment	6.0%

4. INVESTMENTS IN ASSOCIATED ORGANIZATIONS:

Investments in associated organizations consisted of the following at December 31, 19X9 and 19X8:

	<u>19X9</u>	<u>19X8</u>
Capital Term Certificates of the National Rural Utilities Cooperative Finance Corporation (NRUCFC)	\$ 385,193	\$ 288,261
NRUCFC Patronage Capital Credits	5,065	3,537
Other	<u>1,000</u>	<u>1,000</u>
	<u>\$ 391,258</u>	<u>\$ 292,798</u>

5. DEFERRED CHARGES:

Following is a summary of amounts recorded as deferred charges as of December 31, 19X9 and 19X8:

	<u>19X9</u>	<u>19X8</u>
Preliminary Surveys 19X0 - X1 Work Plan	\$ 5,666	\$ 1,762

6. PATRONAGE CAPITAL:

At December 31, 19X9 and 19X8, patronage capital consisted of:

	<u>19X9</u>	<u>19X8</u>
Assignable	\$ 255,250	\$ 83,323
Assigned to Date	<u>1,952,448</u>	<u>1,869,125</u>
	2,207,698	1,952,448
Less: Retirements to Date	<u>445,900</u>	<u>425,615</u>
	<u>\$1,761,798</u>	<u>\$1,526,833</u>

Under the provisions of the Mortgage Agreement, until the equities and margins equal or exceed forty percent of the total assets of the cooperative, the return to patrons of contributed capital is generally limited to twenty-five percent of the patronage capital or margins received by the cooperative in the prior calendar year. The equities and margins of the cooperative represent 25.3 percent of the total assets at balance sheet date. Capital credit retirements in the amount of \$20,285 were paid in 19X9.

7. OTHER EQUITIES:

At December 31, 19X9 and 19X8, other equities consisted of:

	<u>19X9</u>	<u>19X8</u>
Retired Capital Credits - Gain	\$ 36,190	\$ 34,990
Donated Capital	<u>17,457</u>	<u>910</u>
	<u>\$ 53,647</u>	<u>\$ 35,900</u>

8. MORTGAGE NOTES - REA:

Long-term debt is represented by mortgage notes payable to the United States of America. Following is a summary of outstanding long-term debt as of December 31, 19X9 and 19X8:

	<u>19X9</u>	<u>19X8</u>
2% Notes due March 31, 19X5	\$1,057,155	\$1,098,700
2% Notes due December 31, 19X6	2,485,927	2,502,370
5% Notes due December 31, 19X6	1,851,033	1,935,315
Less: Current Maturities	<u>(145,000)</u>	<u>(140,000)</u>
	<u>\$5,249,115</u>	<u>\$5,396,385</u>

Unadvanced loan funds of \$285,600 are available to the cooperative on loan commitments from REA.

Principal and interest installments on the above notes are due quarterly in equal amounts of \$99,600. As of December 31, 19X9, annual maturities of long-term debt outstanding for the next five years are as follows:

19X0	\$145,000
19X1	\$150,000
19X2	\$151,500
19X3	\$154,000
19X4	\$155,000

Advance payments of \$252,300 may be applied to the installments.

9. PENSION PLAN:

Substantially all of the employees of the Cooperative are covered by the ABC Retirement and Security Program, a multiemployer plan. Pension expense for the years ended 19X9 and 19X8 was \$22,400.00 and \$20,400.00, respectively.

10. DEFERRED CREDITS:

Following is a summary of the amounts recorded as deferred credits as of December 31, 19X9 and 19X8:

	<u>19X9</u>	<u>19X8</u>
Customer Energy Payments	\$ 6,694	\$ 3,065
Inventory Adjustment	<u>5,210</u>	<u>7,500</u>
	<u>\$ 11,904</u>	<u>\$ 10,565</u>

11. LITIGATION:

The cooperative is a defendant in an action in which the plaintiff claims damages totaling \$200,000 for personal injuries sustained. The action has been dismissed by the District Court, but is on appeal before the State Supreme Court. Management is of the opinion that no liability will be incurred by the cooperative as a result of this action.

12. COMMITMENTS:

Under its wholesale power agreement, the cooperative is committed to purchase its electric power and energy requirements from Central Power Cooperative, Inc., until December 31, 19XX. The rates paid for such purchases are subject to review annually.

[56 FR 63360, Dec. 3, 1991, as amended at 61 FR 109, Jan. 3, 1996]

APPENDIX B TO PART 1773—SAMPLE
AUDITOR'S REPORT FOR A CLASS A
OR B COMMERCIAL TELEPHONE COM-
PANY

Appendix B includes an example of a short-form auditor's report, report on compliance, report on internal controls, financial statements and accompanying notes for a commercial telephone company. The sample auditor's report is intended as a guide only and, while it is recommended that the format be followed, each auditor's report should be prepared to adequately cover the circumstances. To the extent possible, it should be used as a guide in preparing auditors' reports for other types of telephone borrowers.

Exhibit 1—Sample Auditor's Report

Certified Public Accountants, 1600
Main Street, City, State 24105, The
Board of Directors, Center Telephone
Company:

INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying balance sheets of Center Telephone Company as of December 31, 19X9 and 19X8, and the related statements of revenue and patronage capital, and cash flows for the years then ended. These financial statements are the responsibility of Center Telephone Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Center Telephone Company as of December 31, 19X9 and 19X8, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

In accordance with Government Auditing Standards, we have also issued a report dated March 2, 19X0, on our consideration of Center Telephone Company's internal control structure and a report dated March 2,

19X0, on its compliance with laws and regulations.

Certified Public Accountants

March 2, 19X0

Exhibit 2—Sample Report on Compliance When, Based on Assessments of Materiality and Audit Risk, the CPA Concluded It Was Not Necessary to Perform Tests of Compliance With Laws and Regulations

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center Telephone Company

We have audited the financial statements of Center Telephone Company as of and for the years ended December 31, 19X9 and 19X8, and have issued our report thereon dated March 2, 19X0.

We conducted our audits in accordance with generally accepted auditing standards and the Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to Center Telephone Company is the responsibility of Center Telephone Company's management. As part of our audit, we assessed the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants could cause the financial statements to be materially misstated. We concluded that the risk of such material misstatement was sufficiently low that it was not necessary to perform tests of Center Telephone Company's compliance with such provisions of laws, regulations, contracts, and grants.

This report is intended for the information of the audit committee, management, the Rural Utilities Service, and supplemental lenders. However, this report is a matter of public record and its distribution is not limited.

Certified Public Accountants

March 2, 19X0

Exhibit 3—Sample Report on Compliance When, Based on Assessments of Materiality and Audit Risk, the CPA Performed Compliance Testing and Found No Reportable Instances of Noncompliance

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center Telephone Company:

We have audited the financial statements of Center Telephone Company as of and for the years ended December 31, 19X9 and 19X8, and have issued our report dated March 2, 19X0.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to Center Telephone Company is the responsibility of Center Telephone Company's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of Center Telephone Company's compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under Government Auditing Standards.

This report is intended for the information of the audit committee, management, the Rural Utilities Service, and supplemental lenders. However, this report is a matter of public record and its distribution is not limited.

Certified Public Accountants

March 2, 19X0

Exhibit 4—Sample Report on Compliance When, Based on Assessments of Materiality and Audit Risk, the CPA Performed Compliance Testing and Found Reportable Instances of Noncompliance

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center Telephone Company:

We have audited the financial statements of Center Telephone Company as of and for the years ended December 31, 19X9 and 19X8, and have issued our report thereon dated March 2, 19X0.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to Center Telephone Company is the responsibility of Center Telephone Company's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of Center Telephone Company's compliance with certain provisions of laws, regulations,

contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed instances of noncompliance that are required to be reported herein under Government Auditing Standards for which the ultimate resolution cannot presently be determined. Accordingly, no provision for any liability that may result has been recognized in Center Telephone Company's 19X9 and 19X8 financial statements.

[Include paragraphs describing the instances of noncompliance noted.]

We considered these instances of noncompliance in forming our opinion on whether Center Telephone Company's 19X9 and 19X8 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not effect our report dated March 2, 19X0, on those financial statements.

This report is intended for the information of the audit committee, management, the Rural Utilities Service, and supplemental lenders. However, this report is a matter of public record and its distribution is not limited.

Certified Public Accountants

March 2, 19X0

Exhibit 5—Sample Report on Internal Controls When Reportable Conditions Were Found

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center Telephone Company:

We have audited the financial statements of Center Telephone Company as of and for the years ended December 31, 19X9 and 19X8, and have issued our report thereon dated March 2, 19X0.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of Center Telephone Company is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgements by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that the assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance

with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of Center Telephone Company for the years ended December 31, 19X9 and 19X8, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

[Include paragraphs to describe the reportable conditions noted.]

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of Center Telephone Company in a separate letter dated March 2, 19X0.

This report is intended for the information of the audit committee, management, and Rural Utilities Service, and supplemental lenders. However, this report is a matter of public record, and its distribution is not limited.

Certified Public Accountants

March 2, 19X0

Exhibit 6—Sample Report on Internal Controls When No Reportable Conditions Were Found

Certified Public Accountants, 1600 Main Street, City, State 24105, The Board of Directors, Center Telephone Company:

We have audited the financial statements of Center Telephone Company, as of and for the years ended December 31, 19X9 and 19X8, and have issued our report thereon dated March 2, 19X0.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of Center Telephone Company is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of Center Telephone Company for the years ended December 31, 19X9 and 19X8, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of

Rural Utilities Service, USDA

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relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur

and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted other matters involving the internal control structure and its operation that we have reported to the management of Center Telephone Company in a separate letter dated March 2, 19X0.

This report is intended for the information of the audit committee, management, the Rural Utilities Service, and supplemental lenders. However, this report is a matter of public record, and its distribution is not limited.

Certified Public Accountants

March 2, 19X0

EXHIBIT 7 - SAMPLE FINANCIAL STATEMENTS

CENTER TELEPHONE COMPANY
BALANCE SHEETS - DECEMBER 31, 19X9 AND 19X8
ASSETS (Notes 1 and 2)

	<u>19X9</u>	<u>19X8</u>
CURRENT ASSETS:		
Cash - Construction Funds	\$ 21,000	\$ 18,000
Cash - General Funds	128,300	140,083
Telecommunications Accounts Receivable (less accumulated provision of \$11,597 in 19X9 and \$1,490 in 19X8)	139,642	122,623
Notes Receivable	2,500	3,000
Materials and Supplies	103,713	73,964
Prepayments (Note 3)	49,185	62,201
Other Current Assets	<u>1,357</u>	<u>10,131</u>
	<u>445,697</u>	<u>430,002</u>
NONCURRENT ASSETS:		
Nonregulated Investments: (Note 4)		
Net CATV Plant	413,511	407,086
Net Nonregulated Customer Premises Equipment	103,618	- 0 -
Deferred Maintenance and Retirements (Note 5)	<u>40,000</u>	<u>45,000</u>
	<u>557,129</u>	<u>452,086</u>
PROPERTY, PLANT, AND EQUIPMENT: (Note 6)		
Telecommunications Plant in Service	7,401,300	6,650,553
Telecommunications Plant Under Construction	67,626	199,092
Telecommunications Plant Adjustment (Note 7)	<u>176,380</u>	<u>176,380</u>
	7,645,306	7,026,025
Less: Accumulated Provision for Depreciation	<u>1,760,587</u>	<u>1,504,255</u>
	<u>5,884,719</u>	<u>5,521,770</u>
	<u>\$6,887,545</u>	<u>\$6,403,858</u>

The accompanying notes are an integral part of these statements.

CENTER TELEPHONE COMPANY
BALANCE SHEETS - DECEMBER 31, 19X9 AND 19X8
LIABILITIES AND EQUITIES

	<u>19X9</u>	<u>19X8</u>
CURRENT LIABILITIES:		
Accounts Payable	\$ 123,689	\$ 290,484
Notes Payable	61,600	70,400
Advance Billings and Payments	2,137	2,243
Customers Deposits	11,878	4,940
Current Maturities of Long-Term Debt (Note 8)	146,646	145,998
Accrued Taxes	242,076	224,566
Other Current Liabilities	<u>8,500</u>	<u>9,079</u>
	<u>596,526</u>	<u>747,710</u>
LONG-TERM DEBT:		
REA Mortgage Notes (Note 8)	<u>4,592,658</u>	<u>4,128,106</u>
OTHER LIABILITIES AND DEFERRED CREDITS:		
Unamortized Investment Tax Credits (Note 10)	53,078	61,377
Deferred Income Taxes (Note 11)	<u>37,137</u>	<u>35,039</u>
	<u>90,215</u>	<u>96,416</u>
STOCKHOLDERS' EQUITY:		
Capital Stock - Common		
\$2 par value - 300,000 Shares		
Authorized; 102,600 Shares		
Outstanding 19X9 and 19X8	205,200	205,200
Additional Paid-in Capital	820,800	820,800
Retained Earnings (Note 8)	<u>582,146</u>	<u>405,626</u>
	<u>1,608,146</u>	<u>1,431,626</u>
	<u>\$6,887,545</u>	<u>\$6,403,858</u>

The accompanying notes are an integral part of these statements.

CENTER TELEPHONE COMPANY
STATEMENTS OF INCOME AND RETAINED EARNINGS
FOR THE YEARS ENDED DECEMBER 31, 19X9 and 19X8

	<u>19X9</u>	<u>19X8</u>
OPERATING REVENUES:		
Basic Local Network Services	\$ 836,822	\$ 862,205
Network Access Services	125,042	- 0 -
Long Distance Network Services	897,300	775,073
Miscellaneous	144,435	147,100
Less: Uncollectible Revenues	<u>(24,000)</u>	<u>(24,500)</u>
	<u>1,979,599</u>	<u>1,759,878</u>
OPERATING EXPENSES:		
Plant Specific Operations	564,486	480,509
Plant Nonspecific Operations	187,162	393,143
Depreciation and Amortization	274,691	
Customer Operations	94,473	78,772
Corporate Operations	<u>157,453</u>	<u>134,127</u>
	<u>1,278,265</u>	<u>1,086,551</u>
OPERATING TAXES:		
Federal and State Income		
Taxes - Operating (Notes 10 and 11)	159,845	170,687
Other Operating Taxes	225,013	204,230
Provision for Deferred Taxes (Note 10)	31,566	29,468
Investment Credits - Net	<u>6,201</u>	<u>1,640</u>
	<u>422,625</u>	<u>406,025</u>
OPERATING INCOME:	<u>278,709</u>	<u>267,302</u>
FIXED CHARGES:		
Interest on Long-Term Debt	88,432	85,854
Interest Charged to Construction		
- Credit	<u>(2,251)</u>	<u>(1,516)</u>
	<u>86,181</u>	<u>84,338</u>
NONREGULATED INCOME - NET (Note 4)	<u>19,902</u>	<u>10,593</u>
NET INCOME FOR PERIOD	212,430	193,557
Retained Earnings -		
January 1, 19X9 and 19X8	405,626	235,153
Dividends Declared	<u>(35,910)</u>	<u>(23,084)</u>
Retained Earnings -		
December 31, 19X9 and 19X8	<u>\$ 582,146</u>	<u>\$ 405,626</u>
Earnings Per Share of		
Common Stock - Average	\$ 2.07	\$ 1.89

The accompanying notes are an integral part of these statements.

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CENTER COUNTY TELEPHONE COMPANY
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 19X9 AND 19X8

	<u>19X9</u>	<u>19X8</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash Received from Consumers	\$1,962,580	\$1,733,289
Cash Paid to Suppliers and Employees	(1,159,158)	(960,459)
Interest Paid	(86,181)	(84,338)
Taxes Paid	<u>(401,316)</u>	<u>(376,643)</u>
Net Cash Provided by Operating Activities	315,925	311,849
CASH FLOWS FROM INVESTING ACTIVITIES:		
Construction and Acquisition of Plant	(619,281)	(507,617)
Investment in CATV Plant	(6,425)	(18,246)
Investment in Nonregulated CPE	(103,618)	
Plant Removal Costs	(18,359)	(27,216)
(Increase)/Decrease In:		
Materials Inventory	(29,749)	(19,478)
Notes Receivable	500	1,000
Deferred Maintenance and Retirements	5,000	(45,000)
Nonregulated Income	<u>19,902</u>	<u>10,593</u>
Net Cash Used in Investing Activities	(752,030)	(605,964)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Dividends Paid	(35,910)	(23,084)
Debt Proceeds	465,200	386,000
Payments on Short-term Debt	(8,800)	(7,500)
Increase/(Decrease) In:		
Consumer Deposits and Advance Payments	<u>6,832</u>	<u>4,200</u>
Net Cash Provided by Financing Activities	<u>427,322</u>	<u>359,616</u>
Net Increase/(Decrease) in Cash	(8,783)	65,501
Cash - Beginning of Year	<u>158,083</u>	<u>92,582</u>
Cash - End of Year	<u>\$ 149,300</u>	<u>\$ 158,083</u>

The accompanying notes are an integral part of these statements.

CENTER COUNTY TELEPHONE COMPANY
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 19X9 AND 19X8

RECONCILIATION OF NET MARGINS TO NET CASH PROVIDED
BY OPERATING ACTIVITIES:

	<u>19X9</u>	<u>19X8</u>
Net Margins	\$ 212,430	\$ 193,557
Less: Nonregulated Income	<u>(19,902)</u>	<u>(10,593)</u>
Net Income from Regulated Operations	192,528	182,964
Adjustments to Reconcile Net Margins to Net Cash Provided by Operating Activities:		
Depreciation and Amortization	274,691	253,509
Provision for Uncollectible Accounts Receivable	10,107	(3,610)
(Increase)/Decrease In:		
Customer and Other Accounts Receivable	(27,126)	(22,979)
Current and Accrued Assets-Other	8,774	5,119
Prepaid Taxes	10,000	(10,000)
Other Prepaid Expenses	3,016	(5,426)
Increase/(Decrease) In:		
Accounts Payable	(166,795)	(126,472)
Accrued Taxes	17,510	37,742
Other Current Liabilities	(579)	(638)
Deferred Credits	<u>(6,201)</u>	<u>1,640</u>
Total Adjustments	<u>123,397</u>	<u>128,885</u>
Net Cash Provided by Operating Activities	<u>\$ 315,925</u>	<u>\$ 311,849</u>

The accompanying notes are an integral part of these statements.

CENTER TELEPHONE COMPANY
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 19X9 AND DECEMBER 31, 19X8

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Include a brief description of the reporting entity's significant accounting policies in accordance with Accounting Principles Board Opinion No. 22, Disclosure of Accounting Policies.

Disclosure of accounting policies should identify and describe the accounting principles followed by the borrower and the methods of applying those principles that materially affect the determination of financial position, cash flows, and results of operations.

Disclosures of accounting policies do not have to be duplicated in this section if presented elsewhere as an integral part of the financial statements.

2. ASSETS PLEDGED:

Substantially all assets are pledged as security for the long-term debt to REA.

3. PREPAID EXPENSES:

Following is a summary of the amounts recorded as prepaid items as of December 31, 19X9 and 19X8:

	<u>19X9</u>	<u>19X8</u>
Prepaid Taxes	\$10,000	\$20,000
Prepaid Insurance	3,000	3,000
Prepaid Rent	<u>36,185</u>	<u>39,201</u>
	<u>\$49,185</u>	<u>\$62,201</u>

4. NONREGULATED INVESTMENTS:

	<u>19X9</u>	<u>19X8</u>
CATV Plant in Service	\$430,440	\$420,940
CATV Plant Under Construction	<u>9,051</u>	<u>6,500</u>
Total CATV Plant	439,491	427,440
Less: Accumulated Depreciation	<u>25,980</u>	<u>20,354</u>
Net CATV Plant	<u>\$413,511</u>	<u>\$407,086</u>

CATV plant in service and under construction is stated at cost. The company provides for depreciation on a straight-line basis at annual

rates which will amortize the depreciable property over its estimated useful life.

The offering of CATV services does not involve the joint or shared use of assets in the provision of regulated and nonregulated services.

	<u>19X9</u>	<u>19X8</u>
Nonregulated Customer Premises Equipment - Leased	\$109,699	- 0 -
Less: Accumulated Provisions for Depreciation	<u>6,081</u>	<u>- 0 -</u>
	<u>\$103,618</u>	<u>\$ - 0 -</u>

Nonregulated CPE is stated at cost. The company provides for depreciation on a straight-line basis at an annual rate of depreciation which will amortize the cost of the equipment over its estimated useful life. The leasing of nonregulated customer premises equipment does not involve the joint or shared use of assets in the provision of regulated and nonregulated services.

Following is a summary of net income from nonregulated investments for the year ending December 31, 19X9:

	<u>CATV</u>	<u>Deregulated CPE</u>	<u>Total</u>
Income from Operations	\$32,425	\$9,151	\$41,576
Expenses	<u>18,834</u>	<u>2,840</u>	<u>21,674</u>
	<u>\$13,591</u>	<u>\$6,311</u>	<u>\$19,902</u>

Income tax expense totaled \$3,556, of which \$2,883 was applicable to CATV operations and \$673 was applicable to CPE leasing activities.

DEFERRED CHARGES:

The balance consists of the unamortized portion of the unprovided for loss in service value of plant retired.

<u>Description</u>	<u>Date</u>	<u>Original Balance</u>	<u>Unamortized Balance</u>	
		<u>Net of Income-Tax Savings</u>	<u>19X9</u>	<u>19X8</u>
Aerial Plant	1/1/X7	50,000	40,000	45,000

The Public Utilities Commission granted the company permission to amortize this loss over a ten-year period net of income tax savings of \$10,542.

6. INVESTMENT IN TELEPHONE PLANT:

Telephone plant in service and under construction is stated at cost. Listed below are the major classes of the telecommunications plant as of December 31, 19X9 and 19X8:

	<u>19X9</u>	<u>19X8</u>
Land	\$ 64,601	64,601
Motor Vehicles	76,417	76,043
Special Purpose Vehicles	58,908	64,679
Other Work Equipment	43,582	40,022
Buildings	564,509	500,267
Furniture and Office Equipment	87,045	79,039
Central Office Equipment	3,171,162	2,746,871
Customer Premises Wiring	64,231	73,915
Poles, Cables, and Wire	2,458,895	2,300,411
Telecommunications Plant in Service - Unclassified	<u>811,950</u>	<u>704,705</u>
	<u>\$7,401,300</u>	<u>\$6,650,553</u>

The company provides for depreciation on a straight-line basis at annual rates which will amortize the depreciable property over its estimated useful life. Such provision as a percentage of the average balance of telephone plant in service was 7.2 percent in 19X9 and 7.1 percent in 19X8.

Individual plant depreciable rates are as follows:

Motor Vehicles	25%
Special Purpose Vehicles	13%
Other Work Equipment	16%
Buildings	4%
Furniture and Office Equipment	10%
Central Office Equipment	4%
Customer Premises Wiring	10%
Outside Plant - Aerial and Buried Cable	5%
Outside Plant - Pole Lines and Aerial Wire	20%

7. TELEPHONE PLANT ADJUSTMENT:

This adjustment represents the difference between the amount paid for the telephone plant plus associated expenses and the original cost of the plant less the associated depreciation. The company is amortizing the adjustment over a 19 1/2 year period in accordance with an order from the Public Utility Commission.

Annual amortization equals \$9,000.

8. MORTGAGE NOTES:

Long-term debt is represented by mortgage notes payable to the United States of America. Following is a summary of outstanding long-term debt:

	<u>19X9</u>	<u>19X8</u>
5% Notes due December 31, 19X6	\$4,739,304	\$4,274,104
Less: Current Maturities	<u>146,646</u>	<u>145,998</u>
	<u>\$4,592,658</u>	<u>\$4,128,106</u>

As of December 31, 19X9, there were no unadvanced funds.

Principal and interest installments on the above notes are due quarterly in equal amounts of \$63,200. The maturities of long-term debt for each of the five years succeeding the balance sheet date is as follows:

19X0	\$146,649
19X1	\$153,839
19X2	\$155,743
19X3	\$143,000
19X4	\$139,976

The long-term debt agreements contain restrictions on the payment of dividends or redemption of capital stock. The terms of the Mortgage Agreement require the maintenance of defined amounts of member's equity and working capital after payment of dividends. Under these provisions approximately \$293,688 of retained earnings was available for payment of dividends at December 31, 19X9.

9. PENSION PLAN:

Substantially all employees of the company are covered by the XYZ Retirement and Security plan, a multiemployer plan. Pension expense for the years ended 19X9 and 19X8 was \$12,000.00 and \$11,500.00, respectively.

10 INCOME TAXES AND DEFERRED INCOME TAXES:

The company uses a different method of depreciation on plant additions for income tax purposes. As provided by the Economic Recovery Tax Act of 1981, the company has elected to use the Accelerated Cost Recovery System (ACRS) method of depreciation for plant additions after 1980. In addition to the different depreciation practices for book and tax purposes, the company does not capitalize extraordinary maintenance and retirements and cost of removal charges for tax purposes. Provision is made in the statements of income and retained earnings for the taxes deferred as a result of

the above timing differences. The differences between accounting for book and tax purposes pertaining to income taxes and investment tax credits are accounted for using the normalization method of accounting, as is required for property placed in service after December 31, 1980, under the Economic Recovery Tax Act of 1981.

11. INVESTMENT TAX CREDITS:

The company follows the practice of recording investment tax credits as deferred income, to be amortized over the life of the assets providing the credit as required by the Public Service Commission. Accordingly, Federal income tax expense at December 31, 19X9, was reduced \$7,400 by the investment tax credit amortization.

12. COMMITMENTS:

The company has executed contracts for construction programs for approximately \$225,000 at December 31, 19X9. The amount unpaid against these commitments at December 31, 19X9 is \$185,000.

[56 FR 63360, Dec. 3, 1991, as amended at 61 FR 111, Jan. 3, 1996]

APPENDIX C TO PART 1773—ILLUSTRATIVE INDEPENDENT AUDITOR'S MANAGEMENT LETTER

RUS requires that CPAs auditing RUS borrowers provide a management letter in accordance with §1773.34. This letter must be signed by the CPA, bear the same date as the auditor's report, and be addressed to the borrower's board of directors.

Illustrative Independent Auditor's Management Letter

March 15, 19X6

Board of Directors, [Name of Borrower],
[City, State].

We have audited the financial statements of [Name of Borrower] for the year ended December 31, 19X5, and have issued our report thereon dated March 15, 19X6. We conducted our audit in accordance with generally accepted auditing standards, Government Auditing Standards issued by the Comptroller General of the United States, and 7 CFR part 1773, Policy on Audits of Rural Utilities Service (RUS) Borrowers. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of [Name of Borrower] for the year ended December 31, 19X5, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control structure.

A description of the responsibility of management for establishing and maintaining the internal control structure and the objectives of and inherent limitations in such a structure is set forth in our independent auditors' report on the internal control structure dated March 15, 19X6, and should be read in conjunction with this report.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants.

A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure and its operation that we consider to be a material weakness as defined

above. [If a material weakness was noted, refer the reader to the independent auditors' report on internal control structure.]

7 CFR 1773.34 requires comments on specific aspects of the internal control structure, compliance with specific RUS loan and security instrument provisions, and other additional matters. We have grouped our comments accordingly. In addition to obtaining reasonable assurance about whether the financial statements are free from material misstatements, at your request, we performed tests of specific aspects of the internal control structure, of compliance with specific RUS loan and security instrument provisions, and of additional matters. The specific aspects of the internal control structure, compliance with specific RUS loan and security instrument provisions, and additional matters tested include, among other things, the accounting procedures and records, materials control, compliance with specific RUS loan and security instrument provisions set forth in 7 CFR 1773.34 (e)(1), [for telephone borrowers, 7 CFR 1773.34 (e)(2)], related party transactions, and depreciation rates. [For electric borrowers:] The additional matters tested also include a schedule of deferred debits and credits, upon which we express an opinion. In addition, our audit of the financial statements also included the procedures specified in 7 CFR 1773.38–.45. Our objective was not to provide an opinion on these specific aspects of the internal control structure, compliance with specific RUS loan and security instrument provisions, or additional matters, and accordingly, we express no opinion thereon.

No reports (other than our independent auditors' report, our independent auditors' compliance report, and our independent auditors' report on the internal control structure, all dated March 15, 19X6) or summary of recommendations related to our audit have been furnished to management.

Our comments on specific aspects of the internal control structure, compliance with specific RUS loan and security instrument provisions, and other additional matters as required by 7 CFR 1773.34 are presented below.

Comments on Certain Specific Aspects of the Internal Control Structure

We noted no matters regarding [Name of Borrower]'s internal control structure and its operation that we consider to be a material weakness as previously defined with respect to:

- The accounting procedures and records [list other comments];
- The process for accumulating and recording labor, material, and overhead costs, and the distribution of these costs to construction, retirement, and maintenance or

- other expense accounts [list other comments]; and
- The materials control [list other comments].

Comments on Compliance With Specific RUS Loan and Security Instrument Provisions

Management's responsibility for compliance with laws, regulations, contracts, and grants is set forth in our independent auditors' report on compliance dated March 15, 19X6, and should be read in conjunction with this report. At your request, we have performed the procedures enumerated below with respect to compliance with certain provisions of laws, regulations, and contracts. The procedures we performed are summarized as follows:

- Procedure performed with respect to the requirement to maintain all funds in institutions whose accounts are insured by an Agency of the Federal government:

1. Obtained information from financial institutions with which [Name of Borrower] maintains funds that indicated that the institutions are insured by an Agency of the Federal government.

- Procedures performed with respect to the requirement for a borrower to obtain written approval of the mortgagee to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others [see 1773.34 (e)(2)(i) for additional telephone borrower requirements in accordance with 7 CFR 1773.34 (e)] for the year ended December 31, 19X5 of [Name of Borrower]:

1. Obtained and read a borrower prepared schedule of new written contracts entered into during the year for the operation or maintenance of its property, or for the use of its property by others as defined in §1773.34 (e)(1)(ii) [§1773.34 (e)(2)(i) for telephone borrowers]

2. Reviewed Board of Director minutes to ascertain whether board-approved written contracts are included in the borrower-prepared schedule.

3. Noted the existence of written RUS [and other mortgagee] approval of each contract listed by the borrower.

- Procedure performed with respect to the requirement to submit RUS Form 7 or Form 12 [Form 479 for telephone borrowers] to the RUS:

1. Agreed amounts reported in Form 7 or Form 12 [Form 479 for telephone borrowers] to [Name of Borrower]'s records.

The results of our tests indicate that, with respect to the items tested, [Name of Borrower] complied, except as noted below, in all material respects, with the specific RUS loan and security instrument provisions referred to below. With respect to items not tested, nothing came to our attention that

caused us to believe that [Name of Borrower] had not complied, in all material respects, with those provisions. The specific provisions tested, as well as any exceptions noted, include the requirements that:

- The borrower maintains all funds in institutions whose accounts are insured by an Agency of the Federal government [list all exceptions];
- The borrower has obtained written approval of the RUS [and other mortgagees] to enter into any contract for the operation or maintenance of property, or for the use of mortgaged property by others as defined in §1773.34 (e)(1)(ii) [§1773.34 (e)(2)(i) for telephone borrowers] [list all exceptions]; and
- The borrower has submitted its Form 7 or Form 12 [Form 479 for telephone borrowers] to the RUS and the Form 7 or Form 12 [Form 479 for telephone borrowers], Financial and Statistical Report, as of December 31, 19X5, represented by the borrower as having been submitted to RUS is in agreement with the [Name of Borrower]'s audited records in all material respects [list all exceptions].

Comments on Other Additional Matters

In connection with our audit of the financial statements of [Name of Borrower], nothing came to our attention that caused us to believe that [Name of Borrower] failed to comply with respect to:

- The reconciliation of subsidiary plant records to the controlling general ledger plant accounts addressed at 7 CFR 1773.34 (c)(1) [list all exceptions];
- The clearing of the construction accounts and the accrual of depreciation on completed construction addressed at 7 CFR 1773.34 (c)(2) [list all exceptions];
- The retirement of plant addressed at 7 CFR 1773.34 (c)(3) and (4) [list all exceptions];
- Sales of plant material, or scrap addressed at 7 CFR 1773.34 (c)(5) [list all exceptions];
- The disclosure of material related party transactions, in accordance with Statement of Financial Accounting Standards No. 57, Related Party Transactions, for the year ended December 31, 19X5, in the financial statements referenced in the first paragraph of this report addressed at 7 CFR 1773.34 (f) [list all exceptions]; and
- For electric borrowers only: depreciation rates addressed at 7 CFR 1773.34 (g) [list all exceptions].

For Electric Borrowers Only: Detailed Schedule of Deferred Debits and Deferred Credits

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The detailed schedule of deferred debits and deferred credits required by 7 CFR 1773.34 (h) and provided

below is presented for purposes of additional analysis and is not a required part of the basic financial statements. This information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[The detailed schedule of deferred debits and deferred credits would be included here. The total amount of deferred debits and deferred credits as reported in the schedule must agree with the totals reported on the Balance Sheet under the specific captions of "Deferred Debits" and "Deferred Credits". Those items that have been approved, in writing, by RUS should be clearly indicated.]

This report is intended solely for the information and use of the board of directors, management, and the RUS and supplemental lenders. However, this report is a matter of public record and its distribution is not limited.

Certified Public Accountants

[61 FR 113, Jan. 3, 1996]

PART 1785—LOAN ACCOUNT COMPUTATIONS, PROCEDURES AND POLICIES FOR ELECTRIC AND TELEPHONE BORROWERS

Subpart A—[Reserved]

Subpart B—RUS Cushion of Credit Account Computations and Procedures

Sec.

1785.66 General.

1785.67 Definitions.

1785.68 Establishing an RUS cushion of credit payment account.

1785.69 Cushion of credit payment account computations.

1785.70 Application of RETRF cushion of credit payments.

AUTHORITY: 7 U.S.C. 901 *et seq.*; Title I, Subtitle D, sec. 1403, Omnibus Budget Reconciliation Act of 1987, Pub. L. 100-203; Pub. L. 103-354, 108 Stat. 3178 (7 U.S.C. 6941 *et seq.*).

Subpart A—[Reserved]

Subpart B—RUS Cushion of Credit Account Computations and Procedures

SOURCE: 54 FR 13669, Apr. 5, 1989, unless otherwise noted.

§ 1785.66 General.

This subpart B sets forth policies and procedures on the RUS cushion of credit payments program. The cushion of credit payments program will be maintained only for insured loans evidenced by obligations of the Fund. A subaccount within the Fund is hereby established for purposes of promoting rural economic development. It shall be known as the "Rural Economic Development Subaccount." The assets of the subaccount shall be obtained from crediting (on a monthly basis) a sum determined by multiplying the outstanding cushion of credit payments made after October 1, 1987, by the difference (converted on a monthly basis) between the average weighted interest rate paid on outstanding certificates of beneficial ownership issued by the Fund and the 5 percent rate of interest provided to borrowers on cushion of credit payments, repayment of loans made pursuant to Section 313 of the Act, and other sources as provided by law. This subaccount shall be used to provide grants or zero interest loans to borrowers under the Act for the purpose of promoting rural economic development.

§ 1785.67 Definitions.

Accumulated (deferred) interest means interest allowed to accumulate up to, and including, the basis date of RUS notes covering loans approved before June 5, 1957. The accumulated interest is payable in equal periodic installments over the remaining life of the notes.

Act means the Rural Electrification Act of 1936, as amended (7 U.S.C. 901 *et seq.*).

Advance payment means a voluntary unscheduled payment on an RUS note, made prior to October 2, 1987, credited to the advance payment account of a borrower.

Cushion of Credit Payment means a voluntary unscheduled payment on an RUS note made after October 1, 1987, credited to the cushion of credit account of a borrower.

Current interest means interest payable periodically as it accrues.

Fund means the Rural Electrification and Telephone Revolving Fund established pursuant to the Act.